



Prospect Theory & Gain Aversion: How People Make Decisions

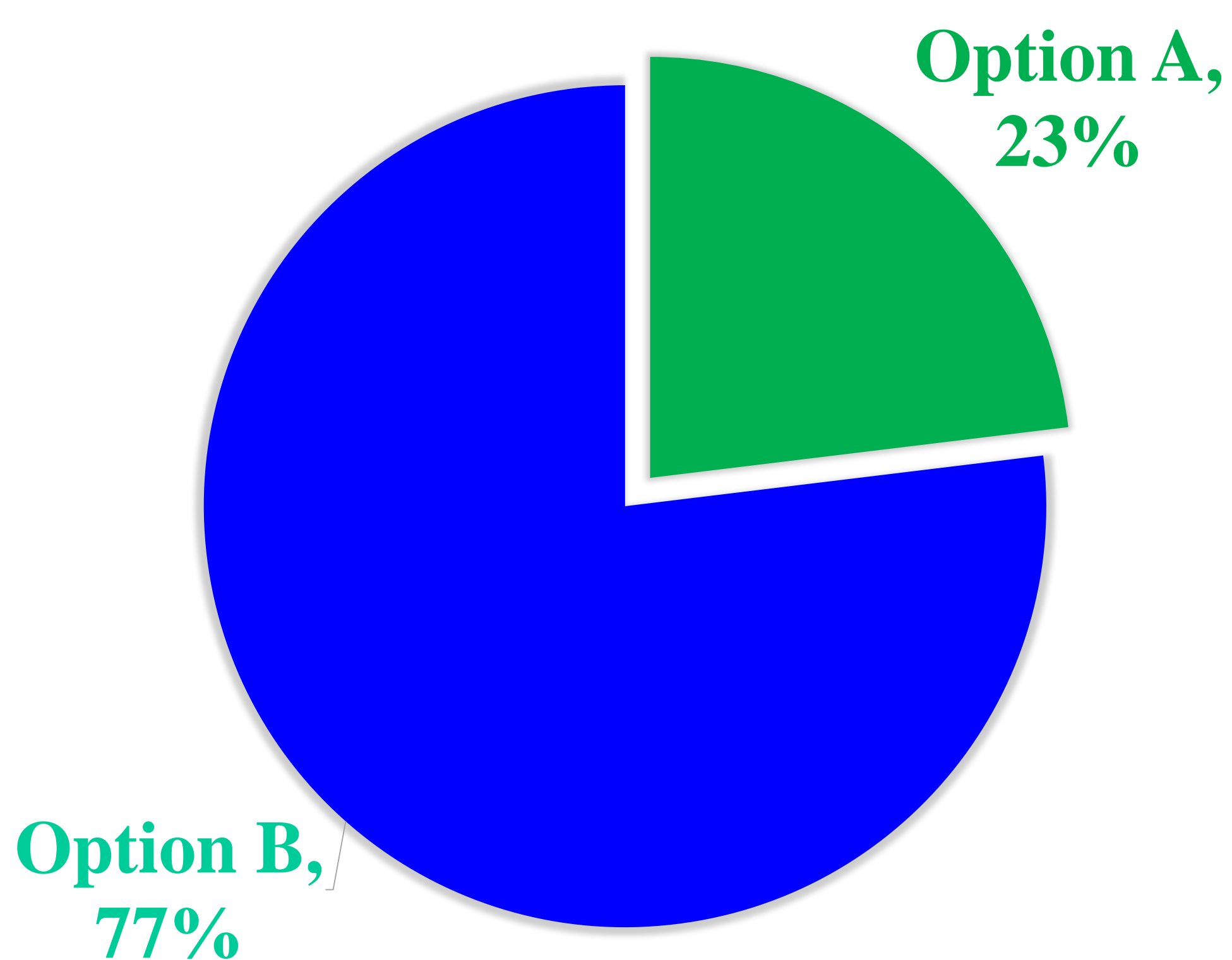
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Situation 1

You have invested your money in the market but due to the poor performance of the market, you are very worried that you might have to suffer a huge loss. You contacted your broker and ask him to sell your shares as soon as possible but due to the poor performance of the market, he gave you options to choose from and now you have to decide.

The options your broker gave you is:
A) a sure loss of \$ 8,000 if you sell your shares now.
B) an 80% chance of losing \$ 10,000 and 20% chance of losing \$ 0, if you wait for a month.

Which option would you choose?



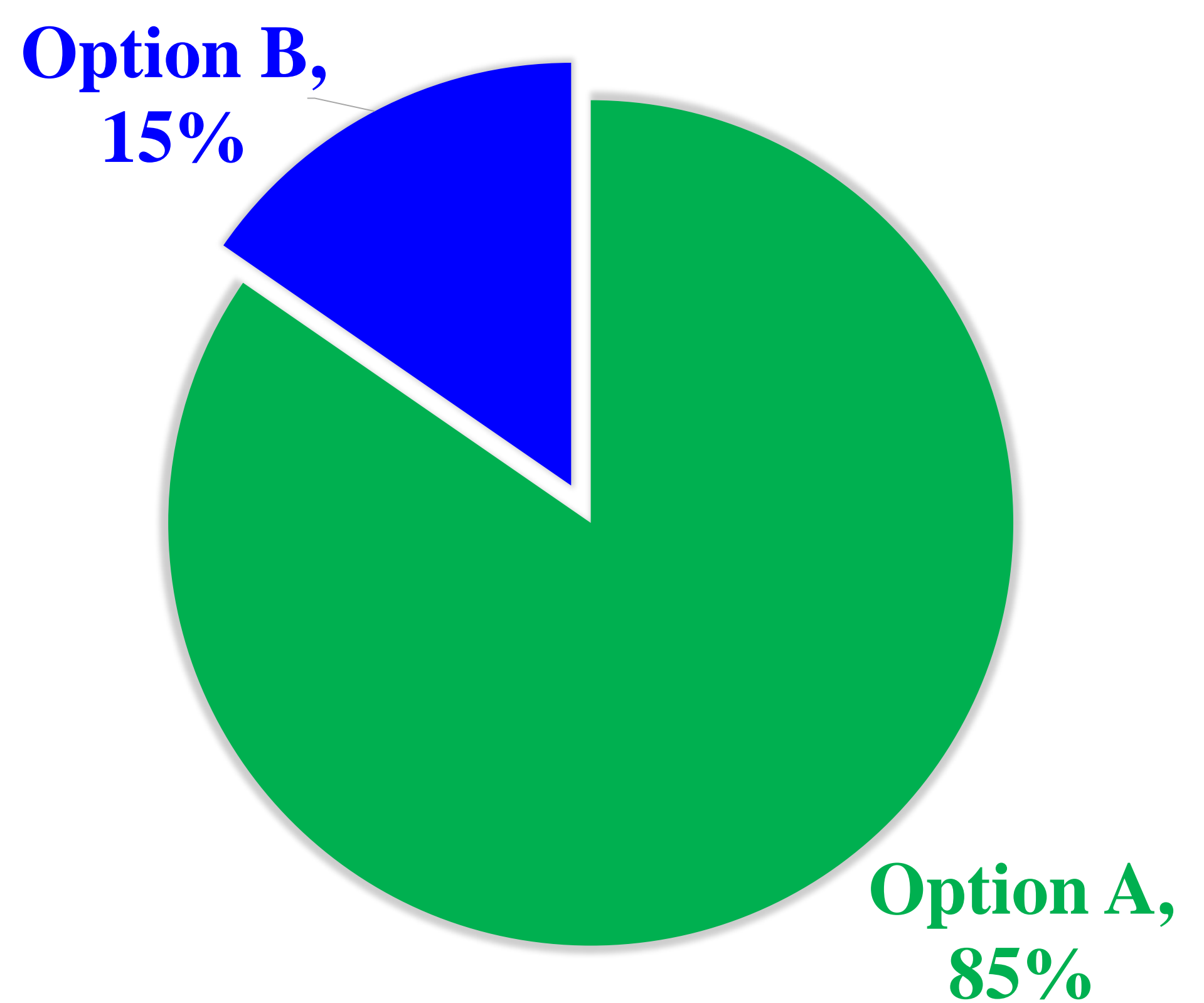
When dealing with losses, people treat loss in the opposite manner as gains. When aiming to avoid a loss, people become risk seeking and take the gamble over a sure loss in the hope of paying nothing. **Note also that the overall expected value (or outcome) of each choice is equal.**

Situation 2

You have invested your money in the market and since the market is performing very well these days, you are very positive that you going to have a huge profit. You contacted your broker and ask him to sell your shares as soon as possible but he gave you options to choose from and now you have to decide.

The options your broker gave you is:
A) a sure profit of \$ 8,000 if you sell your shares now.
B) an 80% chance of gaining \$ 10,000 and a 20% chance of gaining \$ 0 if you wait for one month.

Which option would you choose?



When dealing with gains, people are risk averse and will choose the sure gain over a riskier prospect, even though with the risk there is a possibility of gaining a larger reward. **Note also that the overall expected value (or outcome) of each choice is equal.**